

Testimony
of
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Federal Deposit Insurance Corporation
Public Hearing on the FDIC Application of
the Proposed
Wal-Mart Bank

Washington, D.C. April 10, 2006



# Testimony of Steve Andrews Public Hearing on the FDIC Application of the Proposed Wal-Mart Bank

I am Steve Andrews, President and CEO of Bank of Alameda, a \$250 million asset community bank serving small businesses in Alameda, a city of 76,000 located on the San Francisco Bay across from the Port of Oakland. As its immediate past president, I am here today at this important hearing representing the California Independent Bankers which strongly opposes Wal-Mart's application to establish an industrial loan company (ILC).

The California Independent Bankers has 165 member banks and it led the legislative effort in our state in 2002 which closed the ILC loophole and prevented the dangerous mixing of banking and commerce. <sup>1</sup> Our law states that no <u>commercial firm</u> can buy or establish an ILC as of Sept. 2002. <sup>2</sup> It was passed on the eve of Wal-Mart's attempt to purchase a small, brain dead, \$3 million asset ILC.

I personally participated in this successful effort and if I can leave you with one thought this afternoon it would be that we closed this loophole – <u>not for competitive reasons</u>—but because mixing banking and commerce inevitably leads to insidious conflicts of interests which could destroy our diversified financial system. It could weaken the FDIC insurance fund and subdue public confidence in our banking system, as it did in 1929.

It is a most serious issue. California clearly and decisively decided to plug this loophole and prevent further commercial ownership of banks because it was prudent to do so. California, the 5th largest economy in the world, did not fear competition, but they fully realized that keeping the ILC loophole open and permitting further commercial ownership of ILCs, threatened the very safety and soundness of our financial system.

Let me quote the words of our Governor when he signed the loophole closing bill: "I am signing (the bill) in accordance with the federal prohibition against mixing banking and commerce, as intended by the seminal 1999 law, Gramm-Leach-Bliley. The U.S. Congress determined that affiliations between banks and nonfinancial, commercial companies pose great risks to the safety and soundness of our financial system, can distort credit decisions, and can lead to an aggregation of economic power that can be injurious to consumers."

It doesn't say anything about competition.

I would like to submit 2 letters for the record in support of closing the ILC loophole submitted at the time by Senator Sarbanes, then Chairman of the U.S. Senate on Banking³ and Congressman James Leach of the House Banking Committee.⁴

<sup>&</sup>lt;sup>1</sup>ICBA/CIB Testimony for the California Assembly Wal-Mart Application for Franklin Bank Hearing, July 2, 2002. See attachment 3.

<sup>&</sup>lt;sup>2</sup> CA Assembly Bill No. 551 signed into law September 30, 2002. See attachment 4.

<sup>&</sup>lt;sup>3</sup> Letter from U.S. Senator Paul Sarbanes, U.S. Senate Committee on Banking, August 30, 2002. See attachment 1.

<sup>&</sup>lt;sup>4</sup> Letter from U.S. Congressman James Leach, House Financial Services Committee, August 30, 2002. See attachment 2.

Senator Sarbanes wrote: "I have long supported the separation of banking and commerce as one of the foundations of the U.S. financial system. As Alan Greenspan, Robert Rubin and Paul Volcker have pointed out, affiliations between federally insured banks and commercial companies pose great risks to the safety and soundness of our financial system, distort credit decisions, and lead to concentrations of economic power that should not be permitted."

Congressman Leach wrote: During the debate on Gramm-Leach-Bliley Congress debated the issue of the separation of banking and commerce. "Congress determined...to maintain the separation between these two activities, a determination in which I strongly concurred."

There are many reasons to oppose Wal-Mart and other commercial firms using the ILC loophole as a back door entry into banking. The primary impetus for the CA legislature was maintaining the separation of banking and commerce.

Granting Wal-Mart's application for an ILC will blow a hole in this separation a mile wide. Please follow the sense of Congress and the California legislature and deny this application.

CHRESTOPHERIA (DODO), CONMICTICATY THAN (DOROGAL, BOYTH BASETTA JACK 1825), MICHES FRANC CHAN BAYN, BOMMAN, NEW YORK SYMM BAYN, BOMMAN, 2011, MILLEN, DESMISIA THOMASE, CANTER, DELAWATE DOROGE STANDOWN, MICHEGAN THE OFFICE MEN MICHEGAN TOWN ERROCH, HENDA HOMEST P. DENNETT, UTAN HOMEST P. DENNETT, UTAN HOMEST P. DENNETT, UTAN HAVE BLAND, CELTRARO HOLLOW BLAND, HOMEST HOLLOW C. DENNETT, WANTA HOLLOW C. DENNETT, WANTA HOLLOW C. DENNETT, WANTA HOLLOW C. DENNETT, WANTA HOLLOW C. DENNETT, MARKA HOLLOW C. DEN

TEVEN E. HARRIS. STAFF DIRECTOR AND GIREF COURSE! WAYNE A. AKERNATHY, REPUBLISAN STAFF DIRECTOR United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510-6075

8-30-02

Honorable Louis J. Papan Chairman Committee on Banking and Finance California State Assembly State Capitol, Room 3173 Sacramento, California 94249

Dear Chairman Papan:.

Thank you for your letter in regard to my views on the separation of banking and commerce. I have long supported the separation of banking and commerce as one of the foundations of the U.S. financial system. As Alan Greenspan, Robert Rubin, and Paul Volcker have pointed out, affiliations between federally insured banks and commercial companies pose great risks to the safety and soundness of our financial system, distort credit decisions, and lead to concentrations of economic power that should not be permitted. You may wish to consider the views of these respected financial leaders, which I strongly share, as you review legislation in California in regard to industrial banks and the mixing of banking and commerce.

Sincerely,

Paul S. Sarbanes

Paul S. Sarlanea.

Chairman



## CONGRESS OF THE UNITED STATES

COMMITTEES: FINANCIAL SERVICES CHAIRMAM EMERITUS

INTERNATIONAL RELATIONS

SUBCOMMITTEE: EAST AGIA AND THE PACIFIC CHAIRMAN

August 30, 2002

The Honorable Louis J. Papen Chairman Committee on Banking and Finance California State Assembly State Capitol, Room 3173 Sacramento, California 94249

## Dear Chairman Papen:

It is my understanding the California Assembly may momentarily be addressing the issue of the separation of banking and commerce. As you may know, in the development of the recently enacted financial modernization legislation -- sometimes referred to as Gramm/Leach/Bliley -- this issue was highly contentious.

Congress ultimately determined to maintain the separation between these two activities, a determination in which I strongly concurred. Avoiding the slippery slope allowing the combining of banking and commerce would represent and following the advice of individuals like Alan Greenspan, Robert Rubin and Paul Volcker, the decision was made not to transform the American system into one like that of the Japanese in which keinetsu-like conglomerates are the rule.

I do not know the precise context in which the Assembly is considering this issue, but would simply stress that the implications for the creation of conflicts-of-interest and the abuses attendant to the concentration of power that are inherent in mixing banking and commerce are very real.

Sincerely.

James A. Leach Member of Congress

JL:bt

ICBA/CIB Testimony for CA Assembly Wal-Mart Application for Franklin Bank Hearing Scheduled for July 2, 2002 @ 1:30

Thank you Chairman Papan and distinguished members of the committee for holding this important and timely hearing. The latest attempt by Wal-Mart Stores, Inc. to enter into the banking business by exploiting California's industrial bank charter raises serious public policy concerns about breaching the fundamental separation between banking and commerce. Additionally, Wal-Mart's maneuver would jeopardize the competitive allocation of business capital and credit in communities throughout California and our nation.

On behalf of the 5,000 members of the Independent Community Bankers of America<sup>1</sup> and the California Independent Bankers, we appreciate the opportunity to express our views before this panel. We understand your prompt attention to this issue and urge this committee and the California Department of Financial Institutions to give serious examination to the apparent breaching of the long-standing partition between banking and commerce now endangered by Wal-Mart's latest bank purchase plans.

Wal-Mart's application to buy Orange-based Franklin Bank of California, with that institution's broad industrial bank charter powers, once again raises very serious public policy issues regarding the appropriate structure, and the safety and soundness, of our financial and economic system. While these concerns have been addressed by lawmakers and regulators before, this latest application represents Wal-Mart's third attempt in as many years to launch into the banking business and combine banking with its retail operations on a nationwide basis. After receiving due consideration and generous public debate, Wal-Mart's two earlier attempts were handily rejected by Congress and federal bank regulators, with the explicit understanding that banking and commerce should be kept separate.

<sup>&</sup>lt;sup>1</sup> ICBA is the primary voice for the nation's community banks, representing 5,000 institutions at nearly 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold nearly \$511 billion in insured deposits, \$624 billion in assets and more than \$391 billion in loans for consumers, small businesses and farms. They employ nearly 231,000 citizens in the communities they serve.

## Wal-Mart's Ongoing Campaign to Enter the Banking Business

### Broken Arrow Savings and Loan

Wal-Mart has embarked on a well-publicized mission to get into the banking business despite existing legal and regulatory barriers established on long-held public policy grounds to prevent the full-blown mixing of banking and commerce in our nation. First, Wal-Mart attempted to enter the banking business in 1999 by exploiting the "unitary thrift loophole" with an application to acquire Broken Arrow, a small Oklahoma-based savings and loan institution. Congress shut down this backdoor approach for a commercial firm to enter the banking business when it passed the Gramm-Leach-Bliley Act of 1999, and the crucial firewall between banking and commerce was protected. Congress definitively closed this unitary thrift loophole by banning the acquisition by commercial companies of unitary thrift institutions after May 4, 1999. Wal-Mart missed this deadline and its application was denied.

Testifying on the unitary thrift loophole, then-Treasury Secretary Robert Rubin warned the Senate Banking Committee that not closing this loophole would "allow a dramatically expanded mixture of banking and commerce...[and] we would have serious concerns about these mixtures." That same concern was echoed by Chairman of the Federal Reserve Board Alan Greenspan who stated in his testimony before the Senate Banking Committee:

In light of the dangers of mixing banking and commerce, the [Federal Reserve] Board supports elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured institution. Failure to close this loophole now would allow the conflicts inherent in banking and commerce combinations to further develop in our economy and complicate efforts to create a fair and level playing field for all financial service providers.

Furthermore, then-House Banking Committee Chairman Jim Leach (R-Iowa), a key drafter of the sweeping 1999 Gramm-Leach-Bliley financial services reform act, stated at the time that without closing the unitary thrift loophole, he would have "done everything in my power to pull the plug on the bill."

#### Toronto-Dominion Bank USA

But again in September of 2001, Wal-Mart attempted to thwart the banking and commerce firewall and engage in the retail banking business by partnering with Toronto-Dominion Bank USA, to initially offer banking services in some 100 Wal-Mart stores. Wal-Mart even planned to permit its retail store employees to perform banking transactions for TD Bank in their stores. Yet again, Wal-Mart's attempts to enter retail banking were blocked by the Office of Thrift Supervision and their plan was thwarted. In what then-OTS Director Ellen Seidman said was "the shortest letter we've ever written," the OTS dismissed the Wal-Mart-TD Bank scheme. The OTS's letter stated that the agreements and plans outlined in the application appeared to give "Wal-Mart illegal control over TD Bank USA and would therefore be deemed a savings and loan

holding company. Second, it appears that the proposal is a circumvention of...the Home Owners Loan Act, which prevents a company engaged in commercial activities from becoming a savings and loan holding company." In light of the OTS's scrutiny, Wal-Mart and TD Bank were forced to withdraw their application.

Despite these earlier denials, Wal-Mart's latest application to exploit the industrial bank charter, an anomaly available in only a handful of states, again raises disturbing public policy concerns involving the full-blown mixing of banking and commerce.

## The Dangers of Mixing of Banking and Commerce are Well Known

The linchpin of the financial and economic system of the United States is the principle of separating banking and commerce. This tradition has resulted in the most vibrant, successful and diversified economic and financial system in the world. The essential walls separating banking and commerce prevent conflicts of interest and undue concentration of resources, and ensure the **impartial allocation of credit** so vital to economic growth and development and to a safe and sound financial system.

The negative experiences and economic consequences witnessed in a number of European and Asian countries are testament to the harmful and destabilizing effects of mixing banking and commerce. One can observe the ongoing strife in Japan's financial sector and economy where the dangerous mixing of banking and commerce was commonplace and a primary factor in the financial sector's ongoing predicament and is now severely restricted. Federal Reserve Board Chairman Greenspan has repeatedly argued that the mixing of banking and commerce presents safety and soundness concerns and poses the specter that the federal safety net protecting depositors of insured institutions will spread to non-depository affiliates, thereby introducing additional risks to the deposit insurance funds.

The latest Wal-Mart application yet again presents the same dangers of concentration of resources and impaired credit availability that would flow from allowing a commercial company such as Wal-Mart to own a bank or thrift. And in Wal-Mart's particular case, these dangers are amplified because of the company's known role in devastating the vitality of many small town centers. Numerous small towns and communities have experienced the devastating loss of locally owned and operated retailers, and disinvestment after Wal-Mart establishes a store on the outskirts of town. The Wal-Mart store in essence becomes the new downtown once the town center has been depleted of viable competitors. Indeed, Wal-Mart Supercenters house under one roof full-line grocery stores along with the 36 general merchandise departments of Wal-Mart (including clothing, health and beauty aids, household, electronics, toys, lawn and garden, jewelry, pharmacy, snack bar or restaurant and shoes), plus specialty shops such as a vision center, tire and lube services, photo processing, dry cleaner, beauty parlor, video rental, etc. Various retail outlets competing with Wal-Mart have charged it engages in predatory pricing

practices to capture market share, then raises prices once competitors have been eliminated.<sup>2</sup>

Because of this common history and experience of many communities, when evaluating the latest application, the ICBA urges the committee's consideration of what will happen to impartial credit availability when the Wal-Mart bank is allowed to siphon deposits from locally-owned and operated community banks, impairing their ability to continue to support economic growth and development in their communities through lending.

As a nationwide operation, will Wal-Mart controlled local deposits be shifted to venues outside the community? Will a local hardware or clothing store, a local pharmacy, or someone wishing to establish a new store, be able to obtain credit from the Wal-Mart bank? The Wal-Mart bank would have no incentive -- in fact it would have a disincentive -- to lend to businesses that compete with its parent company. Instead of making impartial credit decisions based on the creditworthiness of the borrower, the Wal-Mart banks would have incentive to deny credit, not on the merits, but because of a conflict of interest and its relationship with Wal-Mart.

Ownership by Wal-Mart would have a similar effect on the bank's decision-making with regard to credit applications by Wal-Mart suppliers. Again, instead of making credit decisions on the merits of a borrower's creditworthiness, the Wal-Mart bank would have an incentive to favor Wal-Mart's suppliers and disfavor their competitors. Impartial allocation of credit, the triumph of our economic system, could be severely damaged.

### Wal-Mart Efforts Could Aggravate Current Local Funding Challenges

Given the broad ability to collect deposits, there is the genuine danger that Wal-Mart will export deposits out of the local community. This has been the current pattern of the large retailer when it establishes itself in a local community. The retailer's deposits do not stay with local banks, but rather are transferred to the store's central headquarters. This pattern in the past has had a devastating effect on local communities as retail dollars spent in the community are exported elsewhere and do not remain in the community to support local lending and economic development.

The industrial bank charter would allow Wal-Mart to gain deposits by offering certificates of deposits (CDs) and NOW accounts. Additionally, legislative attempts are underway in the U.S. Congress to expand the industrial bank charter's bank powers and allow them to accept demand deposits, in essence giving them full banking powers. Unlike local banks that use their deposits for local lending, deposits collected by an international commercial operation like Wal-Mart would be easily exported outside the local community in which they are collected. Would

<sup>2</sup> See, e.g., When Wal-Mart Pulls Out, What's Left?, New York Times, March 5, 1995; Store Shuts Doors on Texas Town; Economic Blow for Community, USA Today, October 11, 1990; Arrival of Discounter Tears Civic Fabric of Small-Town Life, Wall Street Journal, April 14, 1987.

other banks survive to offer alternative sources of local credit?

A recent study conducted by the Federal Reserve Bank of Kansas City<sup>3</sup> found that community bank funding challenges present a persistent, long-term problem that if not addressed, will "eventually force them to curtail lending to small businesses, farmers, and other local customers – many of whom may have few other places to turn to for their borrowing needs." Wal-Mart's potential exportation of deposits out of a community will act to exacerbate local small business funding challenges.

Simply stated, if Wal-Mart wants to provide retail banking services to its customers without breaching the banking and commerce restrictions, it can and does so simply by partnering with hundreds of local banks that lease space and operate branches within their stores. Therefore, there is no clear public policy reason or increased social benefit from severing local businesses and consumers from their local banks by allowing Wal-Mart to control banking establishments.

Wal-Mart currently claims it will use California's Franklin Bank to process payments. However, its desire and ongoing efforts to enter full-service banking is well known. In fact, Wal-Mart is currently restructuring its failed TD Bank USA proposal to operate banks in its retail stores for resubmission to the OTS.

It defies reason that the world's largest retailer with more than 4400 service outlets would purchase a tiny one-branch, \$2.4 million asset bank and continue to operate the institution as is without a dramatic change in its character, structure, and strategic business focus.

Without greater details as to Wal-Mart's future intention for the purchase of tiny Franklin Bank of California, it is critical to allow broader public comment and regulatory investigation into the imminent dangers and consequences of this proposed transaction which jeopardizes the sound public policy separating banking and commerce. The ICBA and the CIB applaud you Chairman Papan, and members of this committee for recognizing the importance and magnitude of this issue and for conducting this hearing.

#### Conclusion

To preserve the ongoing safety and soundness of the financial services industry, and our nation's economic strength, Wal-Mart's latest attempt to breach the separation of banking and commerce should not go unchallenged. First they tried to exploit the unitary thrift loophole and acquire Broken Arrow Savings and Loan in Oklahoma. Then they tried to operate Toronto-Dominion Bank USA to offer retail banking serviced in stores nationwide. Both of these Wal-

<sup>3 &</sup>quot;The Decline in Core Deposits: What Can Banks Do?" by James Harvey and Kenneth Spong, The Federal Reserve Bank of Kansas City, published in <u>Financial Industry Perspectives 2001</u>.

Marts attempts to get into banking were exposed and blocked. Now, in yet another shot at entering the banking business, Wal-Mart is seeking to acquire Franklin Bank of California. We believe Wal-Mart's latest backdoor entry into full-blown banking services using California's unique industrial bank charter will have serious detrimental consequences on California's robust and competitive community banking industry.

Despite the dramatic changes that have taken place in the delivery of financial services in the U.S. over the last several decades, lawmakers and regulators have recognized that the potential for conflicts of interest when banking and commerce are intermingled have not diminished. The need to keep banking and commerce separate remains essential. Concentration by a few industrial-retail giants in banking services is exactly the type of monopolistic and anticompetitive structures lawmakers have repeatedly prevented. The impartial allocation of capital and credit in this nation is the underpinning for our stable and highly successful economic and financial system. Because of the real public policy concerns and conflicts of interest raised by Wal-Mart's proposed transaction, and the lack of detail regarding the business plan the world's largest retailer has for a tiny, California bank, the ICBA urges the California Department of Financial Institutions to reject Wal-Mart's latest endeavor to skirt the banking and commerce firewall and reject its application to acquire Franklin Bank. Additionally, the California Assembly may need to consider legislation to close this open door to mixing banking and commerce.

#### Assembly Bill No. 551

#### CHAPTER 1162

An act to add Section 701.1 to the Financial Code, relating to financial institutions.

[Approved by Governor September 30, 2002. Filed with Secretary of State September 30, 2002.]

LEGISLATIVE COUNSEL'S DIGEST

AB 551, Papan. Industrial banks: acquisition.

Existing law provides for the regulation of financial institutions, including industrial banks, by the Commissioner of Financial Institutions and by various federal agencies.

This bill would prohibit a person, except as specified, from acquiring control of an industrial bank unless the person is engaged only in the activities that are permitted for a financial holding company as provided in federal law, or the person is a credit union when the industrial bank is a credit union service organization as provided in state law.

The people of the State of California do enact as follows:

SECTION 1. The Legislature finds and declares all of the following:

- (a) The economic strength and general welfare of California depends on strong and sound financial institutions that command the highest levels of public confidence among the citizens of this state.
- (b) California financial institutions are highly monitored and closely supervised by federal and state regulatory agencies that impose strict compliance standards and conduct regular and frequent examinations of those institutions.
- (c) The Banking Law, as amended by Chapter 105 of the Statutes of 2000 (Senate Bill 2148), reclassified industrial loan companies as industrial banks, otherwise subject to all laws and regulations pertaining to commercial banks, except the prohibition against offering demand deposits.
- (d) The chairman of the Federal Reserve Board, in congressional testimony, and many other noted economists, experts, and government officials have noted the dangers of mixing banking and general commerce. Clarification of California public policy with regard to mixing of banking and commerce and to the acquisition of control of California industrial banks is desirable to assure continued public confidence in these institutions.

Ch. 1162 — 2 —

- (e) It is therefore the intent of the Legislature to address these concerns by creating more consistency between state and federal law.
  - SEC. 2. Section 701.1 is added to the Financial Code, to read:
- 701.1. Notwithstanding any other provision of this article, except for those persons approved by the commissioner prior to September 1, 2002, and for those persons who control industrial banks as of September 1, 2002, no person may directly or indirectly, including through any merger, consolidation, or any other type of business combination, acquire control of an industrial bank, as defined in Section 105.5, unless the person is engaged only in the activities permitted for financial holding companies, as provided in Section 103 of the federal Gramm-Leach-Bliley Act (12 U.S.C. Sec. 1843(k)(1)), or is a credit union, as defined in Section 134.5, when the industrial bank is a credit union service organization, as defined in Section 14651. Nothing in this section shall be construed to exempt a person seeking to acquire control of a bank that otherwise qualifies to do so pursuant to this section, from the requirements of Sections 700 to 711, inclusive. For the purposes of this section, the term "control" has the same meaning as in subdivision (b) of Section 700.